No. 16150

In the

United States Court of Appeals

FOR THE NINTH CIRCUIT

MORTIMER A. KLINE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

AND

GORDON OIL COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Appealed from The Tax Court of the United States

BRIEF FOR PETITIONERS

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SUBJECT INDEX

Page

Court Decisions

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To the Honorable Judges of the United States Court of Appeals for the Ninth Circuit:

MORTIMER A. KLINE (herein called Kline) and GORDON OIL COMPANY (herein called Gordon), Petitioners herein, hereby submit this brief in support of their petitions for review of decisions of The Tax Court of the United States and respectfully show:

JURISDICTION AND VENUE

Petitioner Kline was the petitioner in The Tax Court proceeding bearing docket number 57291, which court had jurisdiction of that proceeding pursuant to Section 7442 of the Internal Revenue Code of 1954 (R. 6.) Kline is a resident of Los Angeles, California, with offices at 812 General Petroleum Building, 612 South Flower Street, Los Angeles 17, California (R. 6, 18, 24). His income tax return for the taxable year ended December 31, 1951, the period here involved, was filed with the Collector of Internal Revenue for the Sixth District of California (R. 6, 18, 24), which district is located within the jurisdiction of this Honorable Court.

Petitioner Gordon was the petitioner in The Tax Court proceeding bearing docket number 57292, which court had jurisdiction of that proceeding pursuant to Section 7442 of the Internal Revenue Code of 1954 (R. 9). Gordon was a corporation organized under and by virtue of the laws of the State of California with principal office at 812 General Petroleum Building, 612 South Flower Street, Los Angeles 17, California (R. 9, 21, 25). Gordon filed its income and excess profits tax returns for the taxable period January 1, 1951 to August 31, 1951, the period here involved, with the Collector of Internal Revenue for the Sixth District of California (R. 9, 21, 25), which district is located within the jurisdiction of this Honorable Court.

On March 26, 1958 The Tax Court of the United States entered a decision against Gordon deciding that there are

deficiencies in income and excess profits tax for the taxable period January 1, 1951 to August 31, 1951 in the total amount of $46,256.88 (R. 62), and on March 19, 1958 entered a decision against Kline deciding that he was liable for such deficiencies as transferee of the assets of Gordon (R. 60). Each of the petitioners on June 9, 1958 filed a petition for review of the Tax Court decision in its or his proceeding (R. 62, 68). This Honorable Court has jurisdiction to review the decisions of The Tax Court pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE

This case, which was consolidated by order of this Honorable Court dated June 19, 1958 (R. 77), involves petitions to review decisions of The Tax Court of the United States. The Tax Court decided that Gordon owed deficiencies in income and excess profits tax for the taxable period January 1, 1951 to August 31, 1951 in the amount of $46,256.88 and entered a decision against Kline that he was liable for such deficiencies as the transferee of the assets of Gordon. It has been stipulated that Kline was the transferee of the assets of Gordon upon its complete liquidation in August, 1951 (R. 27). Accordingly, in this case we are concerned with the propriety of the Tax Court's determination that Gordon was not entitled to a claimed loss and had not sustained its burden of proof to establish such loss, and the question at issue is whether Gordon has proven and sustained a recognizable loss in the amount of $82,518.70 upon the sale of its working interest in two oil and

gas leases, subject to a reserved production payment, and all of its other properties except cash and accounts receivable, which other properties had an adjusted basis of $332,518.70, for a consideration of $250,000.00.

SPECIFICATION OF ERRORS

FIRST POINT OF ERROR

The finding of the Tax Court that Gordon had failed to sustain the burden of proof imposed upon it in showing that it sustained a loss of $82,518.70 on the sale by it of its working interest in two oil and gas leases, subject to a reserved production payment, and all of its other properties except cash and accounts receivable, which other properties had an adjusted basis of $332,518.70, for a consideration of $250,000.00 is clearly erroneous and not supported by the evidence.

SECOND POINT OF ERROR

The Tax Court erred in failing to find and hold that Gordon on the aforesaid sale sustained a recognizable loss of $82,518.70.

THIRD POINT OF ERROR

The Tax Court erred in deciding deficiencies in income and excess profits tax due from Gordon in the amount of $46,256.88, and by reason of such decision in deciding deficiencies in the same amount against Kline as transferee of the assets of Gordon.

STATEMENT AND ARGUMENT UNDER FIRST AND SECOND POINTS OF ERROR

FIRST POINT OF ERROR—(Restated)

The finding of the Tax Court that Gordon had failed to sustain the burden of proof imposed upon it in showing that it sustained a loss of $82,518.70 on the sale by it of its working interest in two oil and gas leases, subject to a reserved production payment, and all of its other properties except cash and accounts receivable, which other properties had an adjusted basis of $332,518.70, for a consideration of $250,000.00 is clearly erroneous and not supported by the evidence.

SECOND POINT OF ERROR—(Restated)

The Tax Court erred in failing to find and hold that Gordon on the aforesaid sale sustained a recognizable loss of $82,518.70.

STATEMENT

Gordon was incorporated for the purpose of acquiring, exploring, developing and producing oil and gas properties and throughout the period of its existence conducted that business. On March 22, 1949 Gordon acquired two undeveloped oil and gas leases in the Placerita Field, Los Angeles County, California. On these leases Gordon drilled and equipped 29 producing wells (R. 25).

Kline is a lawyer by profession but also devotes a substantial amount of his time to the oil business as an independent operator (R. 32). There were 32 companies own-

ing properties in the Placerita Field. Kline was familiar with the properties located in that field. (R. 33.)

Kline was acquainted with shareholders in Gordon and Nelson-Phillips Oil Company, which companies owned adjoining leases in the Placerita Field. He had devoted a "great deal" of time to other properties in that field and, upon finding out that differences of opinion had arisen among the shareholders of these companies, reached the conclusion that it might be possible for him to acquire all of the stock of Gordon and Nelson-Phillips Oil Company. To this end he conducted extended negotiations over a period of months. (R. 33.)

Kline conducted his negotiations to acquire all of the outstanding stock of Gordon as a principal and not as an agent for any one. He expected to make a profit in acquiring the stock for his own account. (R. 32.) During the period from March to May, 1951 Kline purchased all of the outstanding capital stock of Gordon for a total consideration of $3,962,-432.54. (R. 25.) He borrowed the funds with which to acquire the Gordon stock from First National Bank in Dallas and secured the loan by a collateral pledge of the Gordon shares. (R. 36.) After Kline had purchased all of the outstanding capital stock of Gordon he took over control of the company and became a director and its president. (R. 33, 34.)

After Kline had acquired control of Gordon he conducted on behalf of Gordon negotiations with Tevis F. Morrow (herein called Morrow) and A. H. Meadows (herein called Meadows) looking toward a sale of assets by Gordon. (R.

34, 35.) Gordon, as a principal, by proper and appropriate corporate action, executed under date of May 7, 1951, an assignment to Morrow and Meadows, and upon the execution of that assignment there was paid to Gordon the sum of $250,000.00 in cash. (R. 25, 26.)

The assignment from Gordon to Morrow and Meadows (R. 25, Exh. 3-C) provides in part as follows: (The provisions quoted below are those contained in the Tax Court opinion.)

> "For a valuable consideration, cash in hand paid unto Assignor [Gordon] by Assignee [Morrow and Meadows jointly], the receipt of which is hereby acknowledged, and in consideration of the strict and punctual performance by Assignee, its representatives and assigns, of the covenants herein provided to be kept and performed by Assignee, its representatives and assigns, and, subject to the exception and reservation hereinafter stated, Assignor does hereby grant, bargain, sell, convey, assign, transfer, set over and deliver unto Assignee all interests in lands wherever situated and all easements, permits, licenses, servitudes and rights of every character which are useful or appropriate in exploring for, developing, operating, treating, storing, or transporting oil, gas or other minerals, on the date hereof owned or controlled by Assignor, * * * *together with all improvements and all the interests of Assignor in all personal property situated upon or used in connection with mining operations on said lands, and all other tangible personal property or interests therein now owned by Assignor, and all other properties and interests in properties of whatsoever kind or character, except accounts receivable and moneys on hand or on deposit, now owned by Assignor.*
>
> * * * * *

"Assignor hereby excepts from this conveyance and does hereby reserve unto itself, its successors, representatives and assigns, as a limited overriding royalty interest or production payment free of all development, operation, production and other costs and expenses of any kind whatsoever, subject to the limitation hereinafter set forth, an undivided eighty-five per cent (85%) (hereinafter sometimes referred to as the 'reserved share,') of 'Assignor's interests,' as hereinafter defined, in all of the oil, gas, casinghead gasoline and other hydrocarbons and other minerals in, under and upon, or that may be produced and saved from the lands described in Exhibit 1. (The two oil and gas leases.)

"(1) As used in the foregoing exception and reservation, the expression 'Assignor's interest' means the working interest share of all the oil, gas, casinghead gasoline and other hydrocarbons and other minerals of any kind whatsoever in, under or upon or that may be produced and saved from the lands * * * which, immediately prior to the execution and delivery of this conveyance, was vested in Assignor and which, from and after the effective date hereof, but for the foregoing exception and reservation, would accrue or belong to Assignee, its representatives and assigns, by virtue of this conveyance.

* * * * *

"(3) The foregoing exception and reservation shall be effective as of the effective date of this conveyance.

"(4) The foregoing exception and reservation shall remain in full force and effect until such time as Assignor, its successors, representatives and assigns, shall have received out of the net proceeds of the sale of the 'reserved share' of the oil, gas, casinghead gasoline and other hydrocarbons and other minerals of any kind whatsoever the full net sum of Three Million Six Hundred Thousand Dollars ($3,600,000), in cash; plus

"(a) an amount equal to the aggregate of all severance and gross production taxes and all other taxes and assessments of any kind whatsoever levied upon or assessed against or measured by the production accruing to the 'reserved share' and all *ad valorem* taxes and all other taxes and assessments of any kind whatsoever levied upon or assessed against the property interests hereby excepted and reserved, to the extent, but only to the extent, that any of such taxes or assessments are paid by Assignor; plus

"(b) an additional amount equal to interest from May 1, 1951, on the unliquidated balance of the aggregate of said sum and amount at the rate of five per cent (5%) per annum computed monthly on the basis of a 360-day year, 30-day month, on the first day of each month, beginning June 1, 1951.

"The net proceeds of the sale of the 'reserved share' of the oil, gas, casinghead gasoline and other hydrocarbons and other minerals of any kind whatsoever, shall be applied each month by Assignor, its successors, representatives and assigns, first, to the amount equal to interest as specified in subparagraph (4) (b) above; then to the amount equal to the aggregate of all taxes and assessments that are paid by Assignor as specified in subparagraph (4) (a) above; and then to the sum first specified in this paragraph (4).

"(5) It is further understood that upon the aggregate sum and amounts above provided for being paid to and received by Assignor, its successors, representatives and assigns, all rights, titles, and interests hereby reserved unto Assignor shall terminate and thereupon the fractional interest hereby reserved shall be vested in Assignee, its representatives and assigns, free and clear of the exception and reservation herein made, and to evidence the fact, Assignor, its successors, representatives and assigns, will at any time and from

time to time execute and deliver on request all necessary and appropriate acquittances.

"(6) It is understood that Assignee shall never personally be liable for payment of the above described production payment and that Assignor and its successors, representatives and assigns, shall look exclusively to the oil, gas and other minerals reserved herein for the payment thereof, and that Assignor, its successors, representatives and assigns, shall have no lien whatsoever for the payment of said production payment, provided that nothing in this paragraph contained shall impair the obligation of Assignee under subparagraphs (g), (h) and (i) of Paragraph 10 hereof to account to Assignor, its successors, representatives and assigns, for funds which come into the hands of Assignee and which are attributable to the 'reserved share.'

"(7) *The above reservation and exception shall in no sense extend to any lease equipment or other personal property which is included in this sale, all of which equipment and personal property is being sold to Assignee without reservation.*

"(8) As a further consideration for this assignment Assignee for itself, its representatives and assigns, covenants and agrees with Assignor, its successors, representatives and assigns, until such time as the aggregate sum and amounts above provided for have been fully paid to and received by Assignor, its successors, representatives and assigns, in a good and workmanlike manner, to develop and operate or cause to be so developed and operated, the oil and gas properties described in Exhibit 1, and to produce oil and gas from the respective wells located on the lands described in Exhibit 1, so long as oil, gas or other hydrocarbons can be produced therefrom in paying quantities, and to comply with all the terms and provisions, both express and implied, of the oil, gas and mineral lease described in Exhibit 1, subject to the proviso stated in

the next succeeding sentence hereof. If Assignee elects to abandon or release any specific portion or portions of the properties described in Exhibit 1 from the operation of such oil, gas and mineral lease, in accordance with the provisions contained in such lease, and thereby be relieved from further obligation as to the property which Assignee desires to abandon or release, Assignee prior to such abandonment or relinquishment shall give to Assignor, its successors, representatives and assigns, thirty (30) days' written notice of such intention, and upon written request of Assignor, its successors, representatives and assigns, or any of them, within said period of thirty (30) days, Assignee, its representatives and assigns, shall execute to Assignor, its successors, representatives and assigns, or such of them as may make said written request, or to the nominee of such of them as may make said written request, a reassignment of the interest in the portion of said lease which Assignee desires to abandon or release, by recordable instrument, in which event Assignee shall be relieved from further obligation with reference to the portion so reassigned, but thereby the amount of the aforesaid production payment and the fraction of the production from the remaining lands described in Exhibit 1 out of which it is dischargeable shall not be reduced, affected or impaired. In the event, Assignor, its successors, representatives and assigns, do not desire a reassignment of said interest, then Assignor, its successor, representatives and assigns, shall join in the execution of a recordable release of said portion of said property in accordance with the provisions of said lease, but thereby the amount of the aforesaid production payment and the fraction of the production from the remaining lands described in Exhibit 1 out of which it is dischargeable shall not be reduced, affected or impaired.

* * * * *

"(10) As a further consideration for this assignment, Assignee for itself, its representatives and as-

signs, covenants and agrees with Assignor, its successors, representatives and assigns, until such time as the aggregate sums and amounts above provided for have been fully paid, to

"(a) Deliver at its own expense in quadruplicate to Assignor, its successors, representatives and assigns, on or before November 15 in each year, beginning with the year 1951, a report prepared by a mutually acceptable geologist, setting forth as of the preceding October 1, an estimate of reserves of recoverable oil, gas and other minerals properly allocable to the interests described in Exhibit 1, the future income to be derived from the sale of such recoverable reserves at prices existing as of October 1 of each year [future income to be set forth by years for a six (6) year period and for future years thereafter as a single period]; and such other geological and scientific data as Assignor, its successors, representatives and assigns, shall reasonably request;

"(b) Obtain from time to time and at any time, on request of Assignor, its successors, representatives and assigns, from persons approved in writing by them, any and all geological, engineering and other scientific data and reports regarding the properties described in Exhibit 1 deemed necessary or appropriate by Assignor, its successors, representatives and assigns, and to deliver the same unto Assignor, its successors, representatives and assigns;

"(c) Deliver in quadruplicate to Assignor, its successors, representatives and assigns, on or before the last day of each month, beginning with the month of June, 1951, a production report in a form approved by Assignor, its successors, representatives and assigns, setting forth the results of operations of the properties described in Exhibit 1 during the preceding calendar month;

"(d) Keep true and correct books and records showing the production of all oil, gas, casinghead gasoline and other hydrocarbons and other minerals of any kind whatsoever from the lands described in Exhibit 1 and all necessary information with respect to such production, to show and determine the 'reserved share' of such production;

"(e) Permit Assignor, its successors, representatives and assigns, and the accredited agents and nominees of any of them, at all times to go upon, examine, inspect and remain on all lands described in Exhibit 1, and to examine, audit and make excerpts from any and all books and records of Assignee, its representatives and assigns, regarding the lands and properties described in said exhibit and the production from said lands;

"(f) Deliver to the credit of Assignor, its successors, representatives and assigns, into the pipe lines to which the wells may be connected, free of all charges, the 'reserved share' of the oil produced and saved from the lands described in Exhibit 1;

"(g) Account to Assignor, its successors, representatives and assigns, for the net proceeds of the sale of the 'reserved share' of the gas, casinghead gasoline and other hydrocarbons other than oil produced from the lands described in Exhibit 1;

"(h) Pay to Assignor, its successors, representatives and assigns, the proceeds of the sale of the 'reserved share' of the oil produced and saved from any lands described in Exhibit 1, which on the date hereof is subject to a crude oil sales contract under the terms of which Assignor is not entitled to be paid direct by the purchaser of such production for the 'reserved share';

"(i) Account to Assignor, its successors, representatives and assigns, for the 'reserved share' of

all gas produced from any lands described in Exhibit 1, which on the date hereof is subject to a gasoline extraction contract under the terms of which Assignor is not entitled to be paid direct by the purchaser of such production for the 'reserved share';

"(j) Pay all taxes and assessments of any kind whatsoever levied upon or assessed against or measured by the production by Assignee of oil, gas, casinghead gasoline and other hydrocarbons or other minerals of any kind whatsoever from the lands described in Exhibit 1, and all *ad valorem* taxes and all other taxes and assessments of any kind whatsoever levied upon or assessed against the lands and properties described in Exhibit 1, which are due and payable after the effective date hereof;

"(k) Comply with all laws and regulations pertaining to the exploration and development of the lands described in Exhibit 1 and the conduct of all operations under the oil and gas mining lease described in said exhibit;

"(l) Pay all costs and expenses incurred in developing and operating the lands described in Exhibit 1 and not permit any mechanic's, materialmen's or laborer's liens to attach to said lands or any interest therein or any personal property thereon.

"(11) An event of default will occur upon the happening of any one or more of the following events:

"(a) Should Assignee, its representatives or assigns, in any respect fail strictly and promptly to keep and perform or to observe any one or more of the conditions, obligations, covenants, promises and undertakings herein provided to be observed, kept and performed by it, and such failure to observe, keep and perform any one or more of such conditions, obligations, covenants,

promises and undertakings continues for thirty (30) days after demand for performance is made in writing on Assignee, its representatives and assigns, or any one or more of them, by Assignor or those successors, representatives and assigns of Assignor at the time holding at least an undivided two-thirds (⅔) of the rights, titles and interests hereby reserved unto Assignor; or

"(b) Should there be appointed a receiver of Assignee, its representatives or assigns, or of any of its properties; or

"(c) Should Assignee, its representatives or assigns, be adjudicated an involuntary bankrupt, by a court of competent jurisdiction; or

"(d) Should Assignee, its representatives or assigns, apply to be adjudicated a bankrupt; or

"(e) Should an assignment be made by Assignee, its representatives or assigns, for the benefit of creditors; or

"(f) Should Assignee, its representatives or assigns, fail for sixty (60) days after any money judgment against it shall have become final, to pay such judgment.

"On the occurrence of any event of default, Assignor or those successors, representatives and assigns of Assignor at the time holding at least an undivided two-thirds (⅔) of the rights, titles and interests hereby reserved unto Assignor, shall thereupon or thereafter have the continuing and absolute right, privilege and option, until the limited overriding royalty interest or production payment herein reserved has been fully paid, liquidated and discharged, to take over, hold, manage, operate and develop all or any part of the interest of Assignee, its representatives and assigns, in the oil, gas and mineral lease and oil and gas mining leasehold estate described in Exhibit 1 and the lands and properties covered thereby, together

with the interest of Assignee in all machinery and equipment of every kind and character located on said lands or which may be used or useful in the operation of said oil, gas and mineral lease, and the further right to sell all of the oil, gas and other minerals of every kind whatsoever produced, saved, derived, obtained or accruing alike to the interest of Assignor and the interest of Assignee thereunder. If such right, privilege and option be exercised, Assignor, its successors, representatives and assigns, shall not be liable to Assignee, its representatives and assigns, or to anyone claiming or to claim under them, or any of them, for any action or failure to act except as to any such act or omission which is the result of actual bad faith.

"If the aforesaid right, privilege and option is exercised, Assignor, its successors, representatives and assigns, shall be entitled to collect the proceeds of the oil, gas and other minerals accruing both to the interest hereby assigned and the interest hereby reserved unto Assignor. It is understood that no duty is hereby imposed on Assignor to exercise such right, privilege and option, but if it is exercised, then for all costs incurred in the preservation, protection, operation and development of said properties, and in the discharge of any obligations appertaining thereto, together with interest at the rate of six per cent (6%) per annum, computed monthly on the first day of each month from the respective dates of outlay on the unliquidated balance of such costs, Assignor, its successor, representatives and assigns, shall be entitled to reimbursement from the proceeds of production accruing to the interest that by this assignment is vested in Assignee, and for the balance, if any, Assignor shall account to Assignee.

"If such right, privilege and option is exercised, it is understood that Assignor, its successors, representatives and assigns, shall have no title or interest of any character in the personal property and equipment on the lands described in Exhibit 1 and in the properties

> and interests in properties conveyed hereby, and shall have solely the entire use of such personal property and equipment, free of any rental costs or other charges whatsoever, for the purpose of operating said premises, and that all such properties shall at all times remain the property of Assignee. Said right, privilege and option may be exercised at any time and from time to time after occurrence of an event of default by Assignor or those successors, representatives and assigns of Assignor at the time holding at least an undivided two-thirds (⅔) of the rights, titles and interests hereby reserved, communicating a desire to take over possession of said properties to Assignee, its representatives or assigns, or any one or more of them, whereupon Assignee, its representatives and assigns, shall immediately deliver possession of said premises and do all other acts and things necessary or appropriate to be done to make such right, privilege and option effective. It is further understood that said right, privilege and option is a continuing option and that no exercise of such right, privilege and option shall be held to exhaust said right, privilege and option, but the same may be exercised at any time and from time to time until the limited overriding royalty interest or production payment herein reserved shall have been fully liquidated and paid. (Parenthetical matter added and emphasis supplied.)

The interest reserved by Gordon in the assignment to Morrow and Meadows would be liquidated in full substantially prior to the exhaustion of the economic life of the two leases and was not tantamount to an overriding royalty. (R. 29.)

At the time of the assignment to Morrow and Meadows, Gordon had fully depleted its leasehold cost in both of the leases but had on hand tangible assets either in or on or pertaining to the above-mentioned leases with a then ad-

justed basis for depreciation or for gain or loss of $332,-518.70. (R. 26, 27.) Gordon intended by its assignment to Morrow and Meadows to dispose of all of its interest in the physical equipment in and on the two leases and other tangible assets pertaining thereto. (R. 35.)

Kline on behalf of Gordon negotiated a sale of the working interest in the two leasehold estates and the sale of all of its other properties except cash and accounts receivable with Morrow and Meadows, principally Morrow. (R. 34, 35.) Gordon, because of disputes among its shareholders, had not kept its physical equipment up to the extent that it would have been maintained by a prudent operator. (R. 36.) The consideration of $250,000.00 paid by Morrow and Meadows to Gordon was agreed upon as a result of the negotiations between them and represented the fair market value, subject to the reserved production payment, of the working interest in the two leases and the tangible property. (R. 35.) Neither Morrow nor Meadows at any time ever had any connection with Gordon as an officer, stockholder, director, or otherwise. (R. 35.)

Following the assignment to Morrow and Meadows, Gordon was dissolved and all of its assets and property then on hand, including the reserved production payment, were distributed in complete liquidation of the company to Kline in cancellation and redemption of all of its outstanding stock. (R. 27.) After Gordon was dissolved and liquidated Kline, as a principal, sold the reserved production payment which he had received in liquidation of Gordon at par, that is $3,600,000.00, to a purchaser with whom he

never had any connection. (R. 35, 36.) After the sale of the reserved production payment Kline paid off the indebtedness he had incurred with First National Bank in Dallas in connection with procuring a loan from that bank with which to acquire all of the outstanding capital stock of Gordon. (R. 36.)

ARGUMENT

It was on the above record that the Tax Court held that Gordon had failed to sustain its burden of proof that it was entitled to a loss of $82,518.70. It is well established that where the findings of the Tax Court are clearly erroneous they may be upset on review. *Wener v. Commissioner, 242 F. 2d 938 (C. A. 9, 1957); National Brass Works, Inc. v. Commissioner, 205 F. 2d 104 (C. A. 9, 1953).*

All of the facts set out in the preceding statement were either stipulated by the parties or established by uncontroverted testimony. Such facts demonstrate that Gordon sustained a deductible loss in the amount of $82,518.70 and that the Tax Court finding that the burden of proof was not carried by Gordon is clearly erroneous and without support in the evidence.

The assignment from Gordon to Morrow and Meadows and all other evidence establishes that Gordon sold to them its working interest in the two oil and gas leases and all of its interest in all other properties of whatsoever kind or character except cash and accounts receivable. For the interest assigned to them Morrow and Meadows paid to Gordon a consideration of $250,000.00 in cash. In the as-

signment to them Gordon reserved unto itself, its successors and its assigns, a production payment free and clear of all costs of development and operation which was dischargeable out of 85% of the proceeds of the sale of runs accruing to the interest in the two oil and gas leases with which Gordon was invested immediately prior to the assignment to Morrow and Meadows in the principal sum of $3,600,000.00, plus additional amounts equal to the aggregate of all severance, gross production or other taxes measured by production accruing to the reserved payment and all ad valorem taxes assessed with respect thereto and paid by Gordon, and an amount equal to interest at the rate of 5% per annum on the unliquidated balance of said sum.

Gordon at the time of the sale to Morrow and Meadows had no unrecovered leasehold cost. It had an adjusted basis in the physical equipment and inventory in and on or pertaining to the leasehold estates of $332,518.70. It only received from Morrow and Meadows a cash consideration of $250,000.00. It did not therefore recover through the medium of that payment a cost basis of $82,518.70 and such has been recognized and admitted by respondent. (R. 31.) In light of such admission, the real question is not whether the existence of such loss has been established, but whether such unrecovered cost constitutes a deductible loss sustained on the sale or must be allocated to and become the basis of the production payment reserved by Gordon. (R. 31.)

The Tax Court did not really address itself to this pivotal question and certainly did not decide it. Be that as

it may, it stated that "the difficulty with petitioners' position is that the record fails to support their assumption that the tangible property was sold for $250,000.00 and there is no convincing evidence that the consideration passing to the seller in respect of the tangible property was less than its adjusted basis." Such statement fails to take cognizance of what was actually sold to Morrow and Meadows, or the consideration for the same. What was sold to Morrow and Meadows was the working interest in the two leases subject to the reserved production payment and the tangible property, and for such properties a consideration of $250,000.00 was paid. The petitioners are therefore not placed in a position of having to establish that only $250,000.00 was paid for the tangible property, but are placed in a position of demonstrating that for all properties sold to Morrow and Meadows, which included the working interest in the two leases as well as the tangible property, a consideration of only $250,000.00 was paid.

The uncontroverted facts make it plain that the only consideration received by Gordon was the sum of $250,000.00. It is axiomatic that the best evidence of value of a property is the price at which the property changes hands in the market place. Fair market value has been defined as "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under any compulsion to buy nor sell and both being reasonably informed as to all relevant facts." *Estate of Singer v. Shaughnessy, 198 F. 2d 178 (C. A. 2, 1952); O'Malley v. Ames, 197 F. 2d 256 (C. A. 8, 1952); A & A*

Tool & Supply Co. v. Commissioner, 182 F. 2d 300 (C. A. 10, 1950).

The record is clear that Gordon made the sale to Morrow and Meadows as a principal. Neither of the buyers had any connection whatsoever with Gordon. Kline, the president and sole stockholder of Gordon, devoted a substantial amount of time to an independent oil operation and was familiar with the properties located in the Placerita Field. He therefore was in a position to know the value of the properties owned by Gordon. Moreover, he was familiar with the condition of the physical equipment actually on the two leaseholds. He conducted arm's length negotiations with Morrow and Meadows, principally Morrow, and as a result of such negotiations with them a consideration payable to Gordon of $250,000.00 was agreed upon and such in Kline's judgment "represented the fair market value of the equity (the working interest in the two leases and the tangible property) subject to the oil payment." (R. 35; Parenthetical matter added.)

The assignment from Gordon makes it plain that title to the working interest in the oil and gas leases, subject to the reserved production payment, and all of the other properties of Gordon except cash and accounts receivable passed to Morrow and Meadows. Moreover, it was the intention of Gordon to pass title to this extent.

The uncontroverted testimony establishes that Kline devoted a substantial amount of time to an independent oil operation and that he was familiar with the properties in the Placerita Field and that in his judgment the fair

market value of the properties which were sold to Morrow and Meadows was $250,000.00. No where in its findings of fact or opinion did the Tax Court make reference to this uncontroverted testimony, which was introduced without objection. This failure goes to the heart of the case. It cannot be denied that Gordon was a willing seller and that Morrow and Meadows were willing buyers. The transaction was negotiated at arm's length. Kline's testimony establishes a consideration of only $250,000.00, and it is therefore clear that the claimed loss was sustained.

In finding that the petitioners had failed to sustain their burden of proof the Tax Court also relied upon the provisions of the assignment from Gordon to Morrow and Meadows. It reasoned that because, in connection with the production payment reserved by Gordon, Morrow and Meadows covenanted to develop and operate the properties in a good and workmanlike manner and to produce oil and gas so long as they could be produced in paying quantities and because Gordon was entitled to certain visitorial privileges and rights of inspection in connection with covenants contained in the assignment Gordon received additional consideration which may have been paid at least in part for the properties conveyed, thus reducing or eliminating the claimed loss.

The working interest in the leases sold by Gordon was burdened with paying costs of operation and development because Gordon, in reserving the production payment, reserved the same "free of all development, operation, production and other costs and expenses of any kind whatso-

ever." The payment, free of cost, was withheld and reserved in the assignment to Meadows and Morrow and Gordon retained an economic interest in the properties with all the attributes specified in the assignment. *Thomas v. Perkins, 301 U. S. 655, 81 L. Ed. 1324, 57 S. Ct. 911 (1937); Commissioner v. Fleming, 82 F. 2d 324, 327 (C. A. 5, 1936).* One of the attributes was that the retained estate was freed of the burden of development and operation. See *GCM 22730, 1941-1 CB 214, at page 216.* This and all of the other so-called "additional considerations" mentioned by the Tax Court relate solely to the nature of the reserved interest or estate and have nothing whatsoever to do with the properties sold to Morrow and Meadows. They cannot be considered as additional consideration for the working interest in the leases and the tangible property.

The position of the Tax Court overlooks the true nature of a production payment. It is a limited overriding rolyalty, a fundamental characteristic of which is that the leasehold estate is developed and oil and gas are lifted free of cost. This concept of the term comports with the parlance of the oil industry as adopted by the adjudicated cases. Thus, in the case of *Knight v. Chicago Corporation, 183 S. W. 2d 666 (Tex. Civ. App., 1945), aff'd. 144 Tex. 98, 188 S. W. 2d 564 (1945),* the court said:

> "* * * The words actually used in the lease were, 'Lessee * * * shall not make assignments of undivided interests, overriding royalties or oil payments.' These three classes of assignments mentioned are referred to by Professor Summers as per cent. interests. 3 Sum-

mers Oil and Gas, Perm. Ed. 327, § 556. According to Summers this type of assignment had its origin in the attempted development of oil and gas leases by persons of limited capital. A certain percentage of the lessee's interest would be sold in order to raise funds for drilling costs. We think the terms undivided interest, overriding royalties and oil payments have certain well defined meanings in Texas. All three types of interest are carved out of and constitute a part of the working interest created by an oil and gas lease. An overriding royalty is a certain percentage of the working interest which as between the lessee and the assignee is not charged with the cost of development or production. The oil payment is similar to the overriding royalty, except that the interest of the assignee ceases upon his receiving a certain amount of money or value out of oil or gas produced from a certain percentage of the working interest. The interest commonly spoken of as an 'undivided interest' is an undivided percentage of the working interest, which differs from the oil payment or the overriding royalty in that it is chargeable with its pro tanto share of the cost of development and production."

In *Denver National Bank v. State Commission of Revenue and Taxation, 176 Kan. 617, 272 P. 2d 1070 (1954)*, the Supreme Court of Kansas stated:

" * * * The one-eighth share to be paid the landowner or lessor under the common form of lease is known in the trade as royalty. The seven-eighths interest in the oil produced is known as the working interest. Under the simplest situation the parties who owned the lease and drilled the well would own this seven-eighths interest. As it actually works out in practice, however, financial dealings being what they are, several parties may own a share in the working interest. On somebody must fall the expense of raising the oil from the ground and marketing it. Sometimes part of

> the working interest is held by a party free and clear of this expense. Such an interest is called an 'overriding royalty'."

In *Cities Service Oil Company v. Geolograph Company, 208 Okla. 179, 254 P. 2d 775 (1953)*, the Supreme Court of Oklahoma stated that "an overriding royalty is a certain percentage of the working interest which as between lessee and assignee of mineral lease is not charged with the cost of development or production."

In his *Handbook of Oil and Gas Law*, Sullivan states at page 243:

> "*Oil payments* are similar to overriding royalties, i.e., they are assignments or reservations of a fractional part of the working interest which are not charged with the cost of production. They differ in respect to duration: the override continues throughout the life of the lease; the oil payment terminates upon payment of a certain amount of money or value out of oil and gas produced from a stipulated percentage of the working interest."

The Tax Court also mentions that Morrow and Meadows covenanted to operate and develop the two leases in a good and workmanlike manner. This was also an attribute of the reserved interest or estate. Morrow and Meadows also covenanted to comply with the terms and provisions of the two oil and gas leases. On these leases there were 29 producing wells and 31 other companies owned properties in the Placerita Field. There would accordingly, without any provision in the assignment, have been implied to Morrow and Meadows a covenant for diligent and efficient

operation of the leases. Merrill, *Covenants Implied in Oil and Gas Leases (2d Ed. 1940), Sec. 72.* They would also have been required to prevent drainage from the two leases to other properties in the Placerita Field. *Merrill, ibid., Section 107.*

Likewise the so-called visitorial privileges and rights of inspection are clearly attributable only to the reserved production payment and connot be called consideration for the properties assigned to Morrow and Meadows. The assignment provides that Morrow and Meadows agree to permit Gordon, its successors and assigns, and the accredited agents and nominees of any of them, at all times to go upon, examine, inspect and remain on the lands conveyed, and to examine, audit and make excerpts from any and all of their books and records regarding the lands and properties conveyed to them and the production from said lands. That such privileges and rights relate only to the reserved production payment is explicit from the provisions of the assignment providing that all of the equipment on the two leases and personal property are being sold to Morrow and Meadows without reservation.

To say that Gordon received consideration (income or return of capital) as a result of the so-called visitorial privileges, rights of inspection or other covenants contained in the assignment, is to say in another context that a landlord receives consideration (income) when he reserves in a lease the right to inspect periodically the leased premises to ascertain that they are being kept in good repair or reserves in connection with a lease based on a percentage

of gross or net the right to inspect and audit the books and records of the lessee or causes the lessee to covenant to utilize the leased premises in a manner so as to produce the greatest possible rental. The fallacy of any such position as to a landlord is patent. The same is likewise true in this case.

The fact that runs of oil or deliveries of gas accruing to a royalty, an overriding royalty or a production payment are lifted free of cost does not result either at the time of the assignment or later in the realization of income by the party reserving the royalty interest. Such is true because, as has been demonstrated, such is one of the attributes of the reserved or retained interest, and we have been unable to find any case in which respondent ever asserted that income would be realized in such a situation. On the contrary, operating expenses are deductible by the owner of the working interest or leasehold estate which is burdened with the royalty interest, even to the extent that such expenses are incurred in connection with lifting free of cost royalty production. Treasury Regulations 111, Section 29.23(a)-1 and 29.23 (m)-16(b) (3) (ii).

The Tax Court in its opinion was concerned with "juggling the cash payment and the so-called retained interest" and increasing the "consideration in respect of other covenants." It felt by reason of such that it might be possible "to obtain a deduction on account of a loss" that was not in fact sustained. Such concern on the part of the Tax Court has no application to this case. Here there was no juggling. The stipulated facts and uncontroverted testi-

mony establish that the consideration of $250,000.00 paid by Morrow and Meadows to Gordon was arrived at as a result of arms length negotiations between parties acting as principals and between whom there was no connection whatsoever.

It has been demonstrated that the so-called additional considerations are not in reality considerations but only attributes of the production payment reserved by Gordon. It has also been established that the fair market value of the properties sold to Morrow and Meadows, both the working interest and the tangible property, was $250,000.00; that the only consideration received by Gordon from Morrow and Meadows was cash in the amount of $250,000.00; and that Gordon's adjusted basis in the properties sold to Morrow and Meadows was $332,518.70. Accordingly, so far as the maintenance of any burden of proof is concerned, the finding of the Tax Court is clearly erroneous and Gordon is entitled to a deductible loss of $82,518.70. There remains, however, the real question which was not actually reached in the Tax Court opinion. That is whether the unrecovered cost of $82,518.70 may be deducted as a loss or must become the basis of the reserved production payment and consequently become recoverable through the deduction for depletion.

It is clear that in addition to a sale of the working interest, subject to the reserved production payment, Gordon sold all of its other properties except cash and accounts receivable, because the assignment provides that:

> "Assignor (Gordon) does hereby grant, bargain, sell, convey, assign, transfer, set over and deliver unto

> Assignee (Morrow and Meadows jointly)" the aforesaid leases subject to the reserved production payment, "*together with all improvements and all the interest of Assignor in all personal property situated upon or used in connection with mining operations on said lands, and all other tangible personal property or interests therein now owned by Assignor, and all other properties and interests in properties of whatsoever kind or character, except accounts receivable and moneys on hand or on deposit.*" (Parenthetical matter added and emphasis supplied.)

The assignment makes it equally clear that the reservation of the production payment resulted in the retention of no interest by Gordon in the other properties which were sold to Morrow and Meadows, because it specifically states that the reservation of the production payment "shall in no sense extend to any lease equipment or other personal property which is included in this sale, all of which equipment and personal property is being sold to Assignee without reservation."

The assignment accorded to Gordon, its successors, representatives and assigns, on the occurrence of an event of default, the right and option to take over the operation of the leases. But, even in the event of the exercise of such option, the assignment is explicit to the effect that Gordon, its successors, representatives and assigns, would only have rent-free use of such personal property and equipment in the operation of the property and "that such properties shall at all times remain the property of Assignee."

The only possibility of any interest in the personal property becoming again the property of Gordon, its successors,

representatives or assigns, was in the event Morrow and Meadows should elect to abandon all or a part of the leases. Such could not be expected because the reserved production payment was expected to be liquidated and fully discharged substantially prior to the exhaustion of the economic life of the leases. In any event, there was no retention of an interest in the other properties because an affirmative act would be required on the part of Morrow and Meadows, and their successors, representatives or assigns, to revest title to any of such other properties in Gordon, its successors, representatives or assigns.

The intention and the act of Gordon were identical. It intended to and did in fact vest full title in Morrow and Meadows to the working interest in the two leases, subject to the reserved production payment, and all of its other properties except cash and accounts receivable. Accordingly, the loss claimed by Gordon is allowable. The allowance of such loss is compelled by the decision of the Supreme Court in *Choate v. Commissioner, 324 U. S. 1, 89 L. Ed. 653, 65 S. Ct. 469 (1954), affirming 1 T. C. M. 208 (1942).*

In *Choate*, a partnership, of which the petitioner was a member, acquired an interest in an oil and gas lease in 1936. The partnership drilled and equipped six producing wells on the property and operated the same until August, 1938. At that time it sold to Sylva Oil Company for a cash consideration of $110,000, which was not allocated in the contract or assignment, all of its right, title and interest in the lease "together with all wells and the equipment

thereof, including pumps, casings, piping, tanks, lease-house, and all other personal property on or used in connection with said premises, including oil in storage * * *, save and except that assignors herein expressly reserve unto themselves, their heirs and assigns, and do not assign or convey to the assignee hereof 1/8 of the 8/8 of all oil and gas and casinghead gas which may be produced and saved by Sylvia Oil Company, its successors and assigns."

The partnership reported the transaction as a sale and allocated $98,454.70 of the consideration to the leasehold estate and $11,545.20 to equipment in, on or pertaining to the operation of the lease. This allocation resulted in the showing of a net gain from the sale of the leasehold estate of $71,870.92, and a loss from the sale of the equipment of $11,545.30. The Commissioner took the position that the transaction was a sublease inasmuch as an overriding royalty—an interest which would last for the life of the property—had been reserved. He only allowed a deduction from the consideration paid of depletion thereon and the commission paid in respect of the assignment. The Tax Court held the transaction to be a sublease rather than a sale, so that ordinary income subject to the deduction for depletion was realized in respect of the transfer of the leasehold estate. It held, however, that the physical equipment had been sold and that the loss claimed was allowable in respect of the sale of the physical equipment. The Court noted that the assignment involved not only contained "specific reference to the tangible equipment but seems to require the construction that all of petitioners interest for

all time and for all purposes was thereby transferred to the assignee." Such is patently true with respect to the other properties involved in the instant case.

The only difficulty the Tax Court had in allowing the loss in *Choate*, was a sentence in *Cullen v. Commissioner, 118 F. 2d 651 (C. A. 5, 1941)*, to the effect that "the cost of equipment * * * may be recovered by the percentage depletion allowance." The Fifth Circuit, in a related case to *Choate*, pointed out that "equipment cost is recoverable through depreciation allowances and not 'by percentage depletion allowances' as apparently was inadvertently stated in *Cullen v. Commissioner.*" *Hogan v. Commissioner, 141 F. 2d 92 (C. A. 5, 1944), cert. denied, 323 U. S. 710, 89 L. Ed. 571, 65 S. Ct. 36.*

Before the Supreme Court the only question at issue in *Choate* was the propriety of the allowance of the loss on the sale of the equipment. The Commissioner argued that there was no sale of the equipment and that after the partnership transferred its interest in the lease its investment was no longer in the leasehold equipment as such, but was in the retained interest in the oil enterprise which was depletable only because it was measured only by production. In rejecting this argument, the court stated:

> "* * * But there are two difficulties with that argument. In the first place, we find nothing in the Revenue Act of (May 28) 1938, 52 Stat. 447, c 289, 26 USCA Int Rev Acts 1940 ed, p. 995, or in the Treasury Regulations which provides for depletion of equipment used in the operation of oil and gas wells. A deduction

is allowed for depreciation by § 23 (1) 26 USCA Int Rev Acts 1940 ed, p. 1014, which permits a 'reasonable allowance for the exhaustion, wear and tear of property used in the trade or business.' And see Treasury Regulations 101, Art. 23(m)-18. Section 23 (m) provides that in the case of 'mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case' may be taken as a deduction. And see Treasury Regulations 101, Art. 23(m)-10. Depletion is applicable to wasting assets—to the exhaustion of natural resources, not of property used in a business. See 4 Mertens, Law of Federal Income Taxation (1942) § 24.02. That distinction between depletion and depreciation runs through the basis provisions of the Act. See §§ 111(a), 113(a) and (b), 114(a) and (b), 26 USCA Int Rev Acts 1940 ed, pp. 1041, 1048-1054. And the history of the depletion provisions indeed makes clear that only intangible drilling and development costs, not costs represented by physical property, are returnable by way of depletion. See United States v. Dakota-Montana Oil Co., 288 US 459, 77 L. ed. 893, 53 S Ct 435; 4 Mertens, op. cit. § 24.48; Treasury Regulations 101, Art. 23(m)-16(a). In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved for the Tax Court under Dobson v. Commissioner of Internal Revenue, 320 US 489, 88 L. ed 248, 64 S Ct 239, and Wilmington Trust Co. v. Helvering, 316 US 164, 167, 168, 86 L. ed. 1352, 1354, 1355, 62 S Ct 984. Once a sale of the equipment is conceded, it is not denied that petitioner is entitled to an allowance for the unrecovered cost of the equipment transferred. Sections 111(a), 113(a) and (b). No question is presented concerning the allocation of a portion of the purchase price to the equipment."

If possible the assignment involved in the instant case is even plainer than that involved in *Choate* to the effect that the assignor had forever parted with all of its title and interest in and to the working interest in the oil and gas leases and all of its other properties except cash and accounts receivable. Indeed, this case is stronger than *Choate*, because an allocation was made in *Choate* between leasehold estate and equipment. Here Gordon followed the method of reporting set out in *Louisiana Land and Exploration Company, 6 T. C. 172 (1946)*. In *Choate* there was an over-all profit on the transaction; in this case there was a loss. Moreover, *Choate*, for tax purposes, involved a sublease, whereas the sale to Morrow and Meadows was, for tax purposes, a sale as to which long-term capital gain treatment could have been accorded. *Section 117(j), Internal Revenue Code of 1939; Columbia Oil & Gas Co. v. Commissioner, 119 F. 2d 459 (C. A. 5, 1941)*.

In its opinion the Tax Court took the following position:

> "Petitioners' reliance upon *Choate v. Commissioner, 324 U. S. 1*, is misplaced. No issue was raised in that case as to whether a loss was actually sustained; that fact was assumed, and the Supreme Court explicitly noted that no question was 'presented concerning the allocation of a portion of the purchase price to the equipment,' * * *."

That position of the Tax Court is not well taken. The question in *Choate* was the propriety of the allowance of a loss on the disposition of physical equipment. We have demonstrated in this case that a loss of $82,518.70 was actually sustained and proven. True, there was no alloca-

tion of the $250,000.00 between leasehold etsate and tangible property. There was no occasion to make any such allocation in this case as there was in *Choate*. In *Choate* a loss was claimed on the disposition of the physical equipment and a profit was recognized as to a disposition of the leasehold estate. Here the entire consideration of $250,000.00 was paid for the working interest in the two oil and gas leases, subject to the reserved production payment, and all other properties of Gordon except cash and accounts receivable. That consideration lacked $82,518.70 of equalling Gordons adjusted basis in all of the properties sold to Morrow and Meadows. A loss was sustained and the decision in *Choate* as well as *Section 117(j) of the Internal Revenue Code of 1939* compels its allowance.

The respondent recognizes that the basis of Gordon in the other properties transferred to Morrow and Meadows may be offset to the full extent of the $250,000.00 cash payment. He does, however, insist that the remainder thereof become a part of the depletable basis of the reserved production payment. The Tax Court's decision sanctions this position, although it is obviously paradoxical. If Morrow and Meadows had paid to Gordon $400,000.00 for the property transferred to them, then Gordon would have been allowed to offset its full adjusted basis in the other properties against the cash consideration paid. G. C. M. 23623, 1943 C B 313. Inasmuch as Gordon had owned the leases for more than six months, the excess of such price would have been accorded long-term capital gain treatment. *Section 117(j), Internal Revenue Code of 1939; Columbia Oil*

and Gas Company v. Commissioner, supra; *I. T. 3693, 1944, C B 272.* In the Tax Court's view, we therefore have a situation in which gain, but not loss, may be recognized. We find no authority in Section 117(j) or the other pertinent provisions of the 1939 Code to recognize a gain, if one exists, but to disallow a loss in the same type of transaction in which a gain would be recognized.

The properties other than the working interest which were transferred to Morrow and Meadows were either inventory items or properties through which cost was properly recoverable by the deduction for depreciation. Depreciation and depletion are separate and distinct. They do not pertain to the same property interest. Inventory items enter into a determination of gross income. The decision in *Choate* makes it clear that in a taxable transaction there may not be attributed to a retained depletable asset unrecovered cost in an inventory item or a depreciable asset. The transaction involved in this case does not come within any of the non-recognition provisions of the 1939 Code and, accordingly, the unrecovered cost in inventory and depreciable property may not be transferred to the retained depletable asset.

STATEMENT AND ARGUMENT UNDER THIRD POINT OF ERROR

THIRD POINT OF ERROR—(Restated)

The Tax Court erred in deciding deficiencies in income and excess profits tax due from Gordon in the amount of $46,256.88, and by reason of such decision in deciding

deficiencies in the same amount against Kline as transferee of the assets of Gordon.

Under the facts and argument set forth under the First and Second Points of Error it has been demonstrated that Gordon on the sale of its working interest in two oil and gas leases, subject to a reserved production payment, and all of its other properties except cash and accounts receivable sustained a deductible loss of $82,518.70. Accordingly the Tax Court erred in determining against Gordon for the taxable period January 1, 1951 to August 31, 1951 deficiencies in income and excess profits tax in the total amount of $46,256.88. Inasmuch as it erred in such decision as to Gordon, it erred in deciding that Kline was liable for such deficiencies as the transferee of assets of Gordon.

CONCLUSION

The decisions of The Tax Court should be reversed.

Respectfully submitted,

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APPENDIX

EXHIBITS